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Memorandum for: THE RECORD

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DATE 1/31/86DOC NO EUR M 86-20012OCR 3P&PD 1

Stephen Danzansky,

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Senior Director for International Economic Affairs,
NSC, requested the update to help him prepare for
the 31 January - 2 February Sherpa meeting in Hawaii.
The update was delivered to Danzansky -- as well as
Scott Brown at State and Doug Mulholland at Treasury --
on 28 January.

Attachment:
EUR M86-~~1~~0012

29 January 1986

**EUR A**

Office of European Analysis
Directorate of Intelligence

Distribution:

- 1 - Mr. Steven Danzansky
- 1 - OD/EURA
- 2 - EURA Production Staff
- 4 - IMC/CB (7407)
- 1 - NIO/WE
- 1 - A/NIO/Econ
- 1 - C/PES (6F44)
- 1 - D/ALA (3F45)
- 1 - D/OCR (2E60)
- 1 - D/CPAS (7F16)
- 1 - D/OEA (4F18)
- 1 - D/OGI (3G03)
- 1 - D/OIA (3N109)

- 1 - D/NESA (6G02)
- 1 - D/SOVA (4E58)
- 1 - D/OSWR (5F46)
- 1 - DO/EA
- 1 - C/EURA/EI
- 1 - [redacted] OGI/Terrorism Branch (2G17)
- 1 - [redacted] OGI/TID (3G22)
- 1 - [redacted] OEA/NA/J (4G31)
- 1 - [redacted] OGI/ECD (3G46)
- 1 - DO/EUR/ [redacted]
- 1 - DO/EUR. [redacted]
- 1 - [redacted] DO/EUR [redacted]
- 1 - C/EURA/WE
- 1 - DC/EURA/WE
- 1 - EURA/WE/CM

- 1 - EURA/WE/BBC
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ORIG: EURA/WE, [redacted] (28 Jan 86)

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Japan

Prime Minister Nakasone's domestic political standing going into the Summit has been strengthened by pledges from his Liberal Democratic Party (LDP) rivals to put succession maneuvering on hold and cooperate with him to make the Summit go smoothly for Japan. Tokyo, however, continues to worry that it will come under attack because of its domestic economic policies and record 1985 trade surplus of \$42 billion. In response, we expect Nakasone to try to focus discussions on political topics and on less sensitive economic issues, such as employment and Third World debt.

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Macroeconomic Policy. Tokyo continues to balk at suggestions it become a locomotive for world economic growth, although Nakasone's advisors appear divided over whether to stimulate domestic demand. His trade advisory committee is likely to include some recommendations for modest fiscal expansion in its report due in March. The Finance Ministry, however, continues to oppose demand expansion

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Although at the recent G-5 meeting the Japanese pushed for an international effort to lower interest rates, the Bank of Japan is unlikely to reduce interest rates unilaterally in the near term.

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Trade. Tokyo continues to support a new GATT round, hoping it will limit protectionist measures against Japanese products and increase access to LDC markets.

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Third World Debt. Japanese banks are still withholding full support for the Baker initiative

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International Terrorism. The Japanese probably will call for international cooperation in combatting terrorism, but will stop short of seeking a consensus on economic sanctions.

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Other. Nakasone is pushing educational reform in Japan and would like to use the Summit as a forum for his domestic program.



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West Germany

West German views on summit issues have changed little since November. [REDACTED]

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but it continues to worry that summit countries will intensify pressure on West Germany to reflate. [REDACTED]

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Macroeconomic Policy. Bonn will continue to resist calls for reflation and will point out that the West German economic outlook has improved over the past few months--economic growth is now expected to exceed 3 percent in 1986. Bonn--Finance Minister Stoltenberg in particular--will argue that any new fiscal stimulus would lead to higher inflation and derail budget consolidation efforts. Moreover, a unilateral reduction in West German interest rates could reverse the trend toward dollar depreciation, [REDACTED]

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Third World Debt. Bonn will point to last week's endorsement of the Baker plan by West German banks as evidence of the positive role West Germany wants to play on the debt issue. The banks' announcement, however, came only after some government prodding, contains no mention of amounts, and is hedged with conditions that require the government, IMF, and World Bank to play an active role in the program. [REDACTED]

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High Technology. Bonn agreed in December to negotiate a bilateral SDI agreement, but some officials--notably Foreign Minister Genscher--want the agreement to address technology transfer in general and to ensure West German commercial rights to jointly developed technology. [REDACTED]

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Terrorism. Bonn will reaffirm its opposition to economic sanctions against Libya. It will emphasize, however, that it has asked German companies not to take commercial advantage of US sanctions, that German industry has reacted positively, and that economic ties with Libya have been declining steadily for several years. [REDACTED]

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FranceRecent Political and Economic Developments

France is becoming increasingly preoccupied with the National Assembly elections slated for 16 March. President Mitterrand has continued to prepare himself for the expected conservative victory by emphasizing his competence in foreign affairs--the area where he would most likely be able to preserve independent influence. He may also be readying an attempt to rise above the political fray by reminding voters that no matter who controls the National Assembly after March, he will still be President of all the French. For its part, the opposition has begun to lay out its campaign platform--which stresses denationalization and domestic economic liberalization--and to gird itself for a postelection struggle with Mitterrand over the control of French foreign policy.

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The French economy continues to strengthen, however, and the Socialists are starting to get some credit for this in the polls; the latest survey shows them at about 30 percent, a jump of 6-7 percentage points over previous soundings. This may reflect in part recently released statistics showing that French inflation has declined to near 5 percent, and even unemployment appears to be edging downward--to 10.3 percent in December. France enjoyed a small current account surplus last year, and real GDP growth--about 1.1 percent in 1985--will probably remain over 1 percent in 1986.

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We believe that both sides will try to work out

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their differences prior to the Summit to avoid publicly embarrassing France. The Summit will probably be the first major test of will on foreign policy, and both sides are likely to move cautiously. Nonetheless, Mitterrand could still play the spoiler at the Summit, particularly on trade issues, in an attempt to project the image of a staunch defender of French interests--a position the conservatives would find hard to criticize.

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The possible change in governments may also affect French representation at the final Sherpa meeting in April. Attali is closely associated with Mitterrand, and a new conservative Prime Minister may push to replace Attali, or at least send his own representative as well.

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Issues

Trade. Paris remains cool to the idea of the new trade round and is likely to continue dragging its feet at the Summit. Although France ultimately voted in favor of establishing the preparatory committee at the GATT contracting parties meeting in November, Paris was the last holdout in the EC.

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We believe that France will do nothing that would directly block the new round at the Summit, but may use procedural arguments to try to slow its progress.

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Third World Debt. French policy on international debt remains unchanged, despite some press reports to the contrary. During the press conference that followed the Francophone Summit--a meeting between France and 36 African nations--in December, Mitterrand endorsed Senegal's call for an African debt conference. This led to widespread speculation that France was prepared to be more generous in its treatment of Third World debt. US Embassy reporting indicates, however, that Mitterrand's statement left working level French government officials baffled by the apparent policy reversal.

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French officials have since distanced Paris from any specific African debt proposals.

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International Terrorism. France may be more amenable to a Summit statement on combatting terrorism in the wake of the Rome and Vienna airport attacks and the US imposition of economic sanctions against Libya. Although France has refused to join in sanctions--arguing that they will be ineffective and that in any case Paris has already cut back its economic ties with Tripoli--French officials have grown more supportive of enhanced international cooperation against terrorism. [REDACTED]

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G-5 Expansion. France is likely to support Italy's and Canada's bids to join the G-5 if the issue arises at the Summit. Finance Minister Bereznev said in a late January press conference that France favors expanding the Group, and in our view a new government would probably hold to this position. [REDACTED]

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United KingdomRecent Political Developments

Thatcher's domestic political standing has been damaged in recent weeks by an embarrassing battle over the financial rescue of the Westland Helicopter Company. The six-week-old crisis--the most serious in Thatcher's six-and-a-half year tenure as Prime Minister--began when the Cabinet split over whether to support a bid from a US company or a bid from a consortium of European companies to buy out Westland. Two Cabinet ministers have already resigned and Thatcher still faces difficult Parliamentary debates over her handling of the affair. Defense Secretary Heseltine resigned 9 January, criticizing Thatcher for her dictatorial leadership style and accusing both the Prime Minister and Trade Secretary Leon Brittan of working behind the scenes to ensure that the US rescue bid was chosen over the offer of the European consortium. Brittan was forced to resign 24 January after admitting that he had authorized disclosure of a classified government document on Westland. The latest polls, taken soon after Heseltine's resignation, showed the Tories in third place, trailing both the Labor Party and the Social-Democratic/Liberal Alliance. [redacted]

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Issues

Britain's position on most summit issues remains largely unchanged from November, but recent developments indicate some shifts in emphasis. [redacted]

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International Monetary Reform. London continues to believe that the dollar's value must be lowered, but is presently more concerned about sterling because falling oil prices are creating strong downward pressure on the pound. [redacted]

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Trade. In a recent public address, former Trade Secretary Brittan indicated that the upcoming GATT negotiations should focus primarily on barriers to exports of manufactured goods, and that discussion of trade in services and agriculture should be "kept in proportion." According to the US Embassy, British officials also want to limit discussing investment-related issues in the new round. The officials cited the difficulty in distinguishing Western trade considerations from broader economic and social implications of investment policy for LDCs. On the issue of intellectual property rights, [redacted]
[redacted] London is willing to use the GATT to enforce such

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[redacted]

rights, but prefers the World Intellectual Property Organization (WIPO) be the institution in which to reach agreement on the type of protection afforded. The British also seem certain to continue to complain about the Japanese trade surplus. [redacted]

[redacted]

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Third World Debt. London continues to support the Baker plan and British banks have now come onboard, indicating their willingness to increase spending on a case-by-case basis. [redacted]

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High Technology. Since the last Sherpa meeting, Britain has signed an agreement with the United States to participate in SDI research. Nonetheless, the United Kingdom almost certainly will continue to support coordinated West European high-tech research efforts, such as EUREKA. London, in fact, may be eager to step up such European-oriented programs to quell domestic criticism of the government for being the only US ally so far to participate formally in SDI. [redacted]

International Terrorism. The British Government has expressed little support for US sanctions and continues to oppose implementing its own broad economic measures against Libya. London maintains that sanctions are ineffective, and British officials worry that sanctions would set an undesirable precedent for South Africa. Prime Minister Thatcher told a press conference that the UK has "unequivocally" ruled out adoption of sanctions against Libya and that direct military retaliation against non-terrorist targets for the Rome and Vienna incidents could not be considered a "viable diplomatic weapon." London has pledged, however, not to undercut US sanctions and to take the lead within the EC in arguing for stronger counter-terrorism cooperation. [redacted]

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ItalyRecent Political Developments

Differences among the five parties in the coalition government over the 1986 budget and Middle East policy may soon force Craxi to shuffle his Cabinet or resign. Leaders of the coalition parties seem to agree that the fall of the government would lead to another Craxi-led coalition, which might serve only as a caretaker until elections could be held this summer. Craxi would probably favor an election prior to the Summit to capitalize on his recent increased popularity in the polls, but the Christian Democrats will try to put an election off until after their party congress in May. [REDACTED]

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This political infighting appears to be complicating Italy's Summit preparations. Renato Ruggiero, Secretary General of the Foreign Ministry and a Christian Democrat, is serving once again as Italy's Sherpa. [REDACTED]

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IssuesInternational Monetary Reform. [REDACTED]

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[REDACTED] Craxi is increasingly interested in monetary reform and is considering proposing an international system of exchange rate bands--similar to that used in the EMS--for all the major currencies as a way to help stabilize exchange rates. [REDACTED]

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Third World Debt. Craxi probably will continue to champion Third World issues at the May Summit. The Italian Bankers

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[redacted]

Association and Bank of Italy announced support for the Baker plan, although the commercial banks conditioned their support on the government's willingness to relax certain loan regulations and change income tax policies on foreign credits. Craxi will probably stress the importance of approaching the debt problem on a case-by-case basis and is likely to raise the need for some sort of international oversight of debtor countries' adjustment policies. Rome is also concerned that developed countries are abandoning project aid in favor of financial assistance to correct balance-of-payments problems, and Craxi is likely to caution that a more balanced approach is needed. [redacted]

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High Technology. Rome had been moving toward a decision on SDI participation until the parliamentary crisis disrupted cabinet deliberations. The Craxi government currently appears to be weighing the various forms of participation and awaiting the outcome of US-West German negotiations before moving ahead. Italian firms, however, are enthusiastic about SDI research. [redacted]

[redacted]

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International Terrorism. Craxi probably will stress the need for political rather than economic or military solutions to the terrorist problem and is likely to encourage his Summit partners to press for a resumption of Middle East peace talks. Even though he has given strong rhetorical support to US efforts and has initiated a ban on weapons sales to Libya, Craxi is likely to argue that efforts to isolate nations abetting terrorists do not address the fundamental roots of terrorism. [redacted]

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G-5 Expansion. Craxi will almost certainly redouble his efforts to have Italy included in the G-5, if only because winning admittance to the group will enhance Italy's and, therefore, Craxi's international stature. Craxi may be egged on by the Italian press, which caught wind of the government's unsuccessful push to be included in the 18 January meeting of the G-5; Craxi, Foreign Minister Andreotti, and Treasury Minister Goria had sent letters to each of their counterparts in the G-5 asking for Italy to be admitted to the January meeting. Craxi will argue that G-5 decisions have a direct and sometimes massive impact on Italy because of its EMS commitments and that Italy has a right to be included. He would probably favor Canadian inclusion but argue against expanding the group to include all the G-10 countries. [redacted]

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Canada

Ottawa's position on summit issues has changed little since the last sherpa meeting. Several recent events -- the Mulroney-Nakasone meeting in January, the Libyan situation, and the fall of the Canadian dollar -- have reinforced previous positions. [redacted]

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Trade. Canada is increasingly focusing on the GATT and Canada's Sherpa has prepared a draft paper addressing the importance of GATT in the international trading system. The paper calls for an annual review by summit leaders of the positions their respective nations are taking in the MTN. Other proposals include plans to strengthen various GATT institutional arrangements, such as the dispute settlement mechanism. Ottawa believes the GATT is ineffective in resolving disputes associated with subsidies, particularly in the agricultural sector, and supports efforts to curb nontariff barriers. Ottawa may raise these proposals, but we do not believe the Canadians will insist on pushing them against strong opposition from their summit partners. [redacted]

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Third World Debt. After being pressured by the Finance Ministry, most Canadian banks probably will now back the Baker proposal. Many bankers are nervous, however, and would be more willing to increase debt exposure if Ottawa eased the regulatory environment concerning loans to debtor nations. [redacted]

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Terrorism. Ottawa offered strong rhetorical support for the US sanctions against Libya, and has implemented limited measures of its own, including canceling export insurance offered to Canadian firms trading with Libya. The US Embassy in Ottawa reports that in recent meetings with the Japanese Ottawa strongly supported US actions, decried the "limp" European response to terrorism, and pressed Tokyo to be more critical of Libya. [redacted]

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Space Station. After a mid-December meeting with NASA officials, Ottawa now is apparently satisfied with the process which will decide its role in the space station. [redacted]

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G-5 Expansion. Ottawa would like to be included in the G-5 but is not likely to press the issue aggressively. Ottawa fears the G-5 may be taking on additional duties which duplicate efforts undertaken at the G-10 and IMF meetings, in which Canada

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is a participant. Mulroney probably would be satisfied with the present makeup of the G-5, if given assurances the US would consult with Canada before and immediately after the meetings.

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[REDACTED]

European Community

The European Community countries have decided that Dutch Prime Minister Lubbers will attend the Summit in his role as president of the EC Council of Ministers and will share representation with EC Commission President Delors. Although the EC has not changed its positions on major summit issues and hopes to play down trade disputes with the United States at the Summit, the steel trade controversy may toughen EC rhetoric in bilaterals with US officials. [REDACTED]

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Trade. Despite recent complaints about the "aggressive" nature of US trade policy, the main EC fear is US protectionism. EC representatives are likely to give general support to the beginning of a GATT round this fall and emphasize bilateral talks on citrus and steel as the best way to solve these disputes. The EC has not discussed the details of its agenda for the GATT round and, although the Community has said that services ought to be included in the new round, they have not made clear which ones. In addition, the EC has not taken an official stance on high technology as an agenda item; the French, in particular, are resisting the definition of high-tech as a separate trade category. The EC probably will support the US position on intellectual property and counterfeiting but is unlikely to go along with any moves in the GATT forum that would fundamentally affect its Common Agricultural Policy. [REDACTED]

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Meanwhile, the longstanding dispute between the United States and the Community over steel probably will heat up. EC foreign ministers almost certainly will agree to retaliate against US restrictions on EC semi-finished steel by imposing quotas on imports of US fertilizer, coated paper, and bovine fat. The Dutch, as current EC Council president, are pushing for a return to the bargaining table to avoid further escalation of the dispute. The effective date of the quotas probably will be moved to 15 February from 1 February to allow more time for negotiations. [REDACTED]

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International Terrorism. We believe EC representatives will come to the Summit ready to join with the United States and West European countries in a general condemnation of terrorism but will be unwilling to go along with strong policies directed at specific countries. EC foreign ministers will take some limited steps to combat terrorism at their meeting 27-28 January in Brussels. They also may agree not to undermine economic measures

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taken by the United States against Libya; at the same time, however, they will point out that most West European governments do not have the legal means to restrain firms from increasing commercial ties. [REDACTED]

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